

REPORT ON EXAMINATION  
OF THE  
AMERICAN HEALTHCARE INDEMNITY COMPANY  
AS OF  
DECEMBER 31, 2003

# State of Delaware



## Department of Insurance

Dover, Delaware



I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON EXAMINATION, made as of December 31, 2003 of the

### AMERICAN HEALTHCARE INDEMNITY COMPANY

is a true and correct copy of the document filed with this Department.

ATTEST BY: *Kenneth L. Miller*

DATE: 28<sup>TH</sup> JUNE, 2005



In Witness Whereof, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 28<sup>TH</sup> DAY OF JUNE, 2005.

*Matthew Denn*

Insurance Commissioner


\_\_\_\_\_  
Deputy Insurance Commissioner

**REPORT ON EXAMINATION**  
**OF THE**  
**AMERICAN HEALTHCARE INDEMNITY COMPANY**  
**AS OF**  
**December 31, 2003**

The above captioned Report was completed by examiners of the Delaware Insurance Department.

Consideration has duly been given to the comments, conclusions, and recommendations of the examiners regarding the status of the Company as reflected in the Report.

This Report is hereby accepted, adopted, and filed as an official record of this Department.

A handwritten signature in black ink, appearing to read "Matthew Denn", is written over a horizontal line.

MATTHEW DENN  
INSURANCE COMMISSIONER

DATED this 28<sup>TH</sup> day of JUNE, 2005.

## **TABLE OF CONTENTS**

SALUTATION	1
SCOPE OF EXAMINATION	2
HISTORY	3
CAPITALIZATION	5
MANAGEMENT AND CONTROL	7
TERRITORY AND PLAN OF OPERATION	8
GROWTH OF COMPANY	13
HOLDING COMPANY SYSTEM	14
INTERCOMPANY AGREEMENTS	15
REINSURANCE	16
ACCOUNTS AND RECORDS	23
FINANCIAL STATEMENTS:	24
Analysis of Assets	25
Statement of Liabilities, Surplus and other Funds	25
Statement of Income – Underwriting and Investment Exhibit	26
Surplus as Regards Policyholders	27
Schedule of Examination Changes	27
NOTES TO FINANCIAL STATEMENTS	28
MARKET CONDUCT ACTIVITIES	30
COMPLIANCE WITH PRIOR EXAMINATION	32
SUMMARY OF RECOMMENDATIONS	33
CONCLUSION	33
ACKNOWLEDGEMENT	34
SUBSEQUENT EVENTS	35

March 24, 2005

**SALUTATION**

Honorable Alfred W. Gross,  
Chairman, Financial Condition  
Subcommittee, NAIC  
2301 McGee Street, Suite 800  
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Bureau of Insurance  
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Honorable Matthew Denn,  
Commissioner  
Sate of Delaware  
Department of Insurance  
841 Silver Lake Boulevard, Suite 100  
Dover, Delaware 19904

Dear Commissioners:

In compliance with instructions and pursuant to statutory provisions contained in Certificate of Authority No. 03.011, dated April 7, 2003, an examination has been made of the affairs, financial condition and management of

## **AMERICAN HEALTHCARE INDEMNITY COMPANY**

hereinafter referred to as “Company” and incorporated under the laws of the State of Delaware as a stock company with its statutory home office located at 1 Rodney Square, 10<sup>th</sup> Floor, 10<sup>th</sup> & King Street, Wilmington, DE 19801. The examination was conducted at the main administrative office of the Company, located at 1888 Century Park East, Suite 800, Los Angeles, CA 90067-1708.

The report of such examination is submitted herewith.

### **SCOPE OF EXAMINATION**

The last examination was conducted as of December 31, 1999. This examination covered the period from January 1, 2000 through December 31, 2003, and consisted of a general survey of the Company’s business policies and practices, management, any corporate matters incident thereto, a verification and evaluation of assets and a determination of liabilities. Transactions subsequent to the latter date were reviewed where deemed necessary.

This report is presented on the exception basis. It is designed to set forth the facts with regard to any material adverse findings disclosed during the examination. The text will explain changes wherever made. If necessary, comments and recommendations have been made in those areas in need of correction or improvement. In such cases, those matters were thoroughly discussed with responsible Company officials during the course of the examination.

The general procedure of the examination followed the rules established by the National Association of Insurance Commissioners’ (NAIC) Committee on Financial Condition Examiners Handbook, and generally accepted statutory insurance examination standards.

In addition to items hereinafter incorporated as a part of the written report, the following areas were checked and made part of the work papers of this examination:

Conflicts of Interest  
Corporate Records  
Non-policy Commitments and Contingent Liabilities  
Fidelity Bonds and Other Insurance  
Risk Based Capital  
Salary, Wage and, Employee Benefits  
Statutory Deposits  
Legal Actions  
All Asset & Liability Items Not Mentioned

## **HISTORY**

The Company was originally incorporated October 3, 1980, under the laws of the State of Florida as the General Electric Mortgage Insurance Corporation of Florida, and commenced business pursuant to a Certificate of Authority issued by the Florida Department of Insurance on November 24, 1980.

The Company amended its Articles of Incorporation on September 3, 1985 to change the name of the Company to General Electric Mortgage Reinsurance Corporation and was subsequently sold on February 7, 1986, to General Electric Mortgage Capital Corporation, a Delaware Corporation. The Company was re-domesticated to the State of North Carolina effective July 1, 1989.

Effective July 10, 1991, the Company amended its Articles of Incorporation to change the name of the Company to FG Insurance Corporation.

On March 23, 1992, the Company re-domesticated to the State of Delaware in connection with the purchase by Citibank Delaware. The Company ceased being a direct writer as of June 1, 1995.

Effective March 29, 1996, SCPIE Holdings Inc. (“SCPIE Holdings”), a Delaware corporation, purchased all of the issued and outstanding shares of capital stock from Citibank Delaware pursuant to the Stock Purchase Agreement dated January 26, 1996, as a clean shell. All of the liabilities existing immediately prior to the sale, and any liabilities incurred after closing which arose from the activities of the Company prior to the close, were assumed by Citicorp Assurance Company.

Effective July 16, 1996, the name of the Company was changed to American Healthcare Indemnity Company.

On January 29, 1997, the holding company was reorganized when the Southern California Physicians Insurance Exchange (“the Exchange”) merged with and into SCPIE Indemnity Company (“SCPIE Indemnity”) pursuant to the Amended and Restated Plan and Agreement of Merger dated August 8, 1996, as amended by Amendment No. 1, dated December 19, 1996. As a result of the merger, SCPIE Holdings became the parent company of SCPIE Indemnity and SCPIE Management Company (“SCPIE Management”) became a wholly-owned subsidiary of SCPIE Indemnity. Also on January 29, 1997, the Exchange surrendered its Certificate of Authority to write insurance in the State of California, pursuant to an Application to Withdraw from California as an Insurer filed with the California Insurance Commissioner on May 24, 1996.

On January 30, 1997, SCPIE Holdings became publicly traded on the New York Stock Exchange, pursuant to a Registration Statement, on Form S-1, which was declared effective on January 29, 1997 by the Securities and Exchange Commission. Under that Registration Statement and Prospectus, SCPIE Holdings sold a total of 2,300,000 shares of common stock to the public.



On August 5, 1997, the Board of SCPIE Indemnity approved a dividend payable on September 30, 1997 to its sole shareholder, SCPIE Holdings, in the form of all the stock of SCPIE Management, a wholly-owned subsidiary of SCPIE Indemnity. SCPIE Management and its two subsidiary corporations, SCPIE Insurance Services, Inc. and SCPIE Management Services, Inc. thereby became wholly-owned subsidiaries of SCPIE Holdings. SCPIE Insurance Services, Inc. is a California licensed broker-agent and SCPIE Management Services, Inc., a California corporation, provides management and claims services to unaffiliated entities.

On February 3, 2003, but effective December 31, 2002, the Company's parent, SCPIE Holdings transferred all the Company's issued and outstanding stock to its other wholly-owned direct subsidiary, SCPIE Indemnity.

## **CAPITALIZATION**

### **Common Capital Stock**

The value of Common Capital Stock increased from \$2,500,000 at December 31, 1999 to \$5,000,000 at December 31, 2003 as follows:

Year	Number of Shares Authorized	Number of Shares Outstanding	Par Value Per Share	Common Capital Stock
1999	25,000	25,000	\$100	\$2,500,000
2000	25,000	25,000	100	2,500,000
2001	50,000	50,000	100	5,000,000
2002	50,000	50,000	100	5,000,000
2003	50,000	50,000	100	5,000,000

The authorized shares of the Company increased from 25,000 to 50,000 shares in 2001. The Amended and Restated Certificate of Incorporation, dated December 13, 2001, indicated a

two-for-one stock split whereby each share of company stock outstanding at December 13, 2001 was split and converted into two (2) shares. The Amended and Restated Certificate of Incorporation authorizes 50,000 shares of common capital stock with a par value of \$100 per share or a total Common Capital Stock value of \$5,000,000.

The capitalization related to the newly issued shares (\$2,500,000) was then transferred from the gross paid-in and contributed surplus account to the common capital stock account of the Company in December 2001.

#### Gross Paid-in and Contributed Surplus

Gross Paid-in and Contributed Surplus at December 31, 2003 was \$39,264,000 and was arrived as follows:

Balance December 31, 1999		\$36,764,000
December 2000	\$5,000,000	
December 2001	<u>(2,500,000)</u>	
Net Increase	\$2,500,000	
Balance December 31, 2003		\$39,264,000

Gross Paid-in and Contributed Surplus increased by \$5,000,000 in December 2000 as the result of a capital contribution from SCPIE Holdings. Gross Paid-in and Contributed Surplus decreased by \$2,500,000 in December 2001 due to the aforementioned transfer from the gross-paid-in and contributed surplus account to the common capital stock account.

On February 6, 2003, one hundred per cent (100%) of the Company's shares were transferred from SCPIE Holdings to SCPIE Indemnity. The transfer of the shares was confirmed through a review of the newly issued stock certificate to SCPIE Indemnity. Even though the stock certificate was dated February 3, 2003, SCPIE Indemnity became the parent of American

Healthcare Indemnity Company effective December 31, 2002 (as shown on the 2002 Annual Statement - Schedule Y- Part 1- Organizational Chart).

## **MANAGEMENT AND CONTROL**

The Company's Certificate of Incorporation provides for the Company to be managed by or under the direction of a Board of Directors. Article II, Section 1 of the by-laws states that the Board of Directors shall consist of (4) four members unless changed by amendment to its by-laws. Each director shall be elected for a term of one year and until his successor is elected and qualified. The following Directors were duly elected and serving as of December 31, 2003:

### Directors and Residence

### Principal Occupation

Mitchell S. Karlan, M.D.  
Beverly Hills, CA

Chairman, Physician – Private Practice

Wendell L. Moseley, M.D.  
San Bernardino, California

Retired

Jack E. McCleary, M.D.  
Hidden Hills, California

Retired

Donald J. Zuk  
Manhattan Beach, California

Insurance Executive

Article IV, Section 1 of the by-laws states that the officers of the Corporation shall consist of a President, one or more Vice Presidents, a Secretary, a Treasurer and other officers appointed by the Board. All officers are elected until a successor is elected and qualified or until

earlier resignation or removal. The President shall be a member of the Board of Directors. The following officers were duly elected and serving as of December 31, 2003:

<u>Name</u>	<u>Title</u>
Mitchell S. Karlan, M.D.	Chairman of the Board
Donald J. Zuk	President and Chief Executive Officer
Joseph P. Henkes	Senior Vice President and Secretary
Robert B. Tschudy	Senior Vice President, Chief Financial Officer and Treasurer
Patrick S. Grant	Senior Vice President, Assistant Secretary and Assistant Treasurer
Ronald L. Goldberg	Senior Vice President and Assistant Secretary
Donald P. Newell	Senior Vice President and General Counsel
Timothy C. Rivers	Senior Vice President and Assistant Secretary
Margaret A. McComb	Senior Vice President
Edward G. Marley	Vice President and Controller
James J. Phair	Vice President and Assistant Secretary

## **TERRITORY AND PLAN OF OPERATION**

### **Territory**

At December 31, 2003, the Company was licensed to write business in 47 states and the District of Columbia. The Company is not licensed in Maine, New Hampshire or New York.

### **Plan of Operation**

The Company was acquired to write professional medical malpractice insurance and other insurance, such as errors and omissions coverage and directors and officers' coverage, to the healthcare industry on a national basis. The Company's products were sold to physicians, physician groups, hospitals and other healthcare entities through several channels, including agents and brokers and also directly.

Effective January 1, 1998, the Company acquired the medical malpractice book of business (e.g. medical malpractice, healthcare provider and healthcare facility liability) from Fremont Indemnity Company, pursuant to an Asset Purchase Agreement dated December 18, 1997. Subsequent to this date the Company also started writing these policies directly.

Commencing January 1, 1998, the Company and Brown & Brown, Inc, (“Brown & Brown”), an independent insurance agency, formed an alliance to offer medical professional liability insurance to physicians and small medical groups in selected states. The Company also expanded its operations outside of California by selling professional liability policies to physicians who did not meet the normal underwriting criteria of the Company. These policies were sold through various brokers typically at a higher premium.

The Company’s insurance business is organized into two business segments: direct healthcare liability insurance and assumed reinsurance operations. All of the Company’s business operations (both direct and assumed) are a part of an inter-company pooling arrangement in effect with its affiliates, SCPIE Indemnity Company and American Healthcare Specialty Insurance Company. The Company’s proportionate share of this pooling arrangement is 5%. Refer to the “Reinsurance” caption for further details regarding the inter-company pooling agreement.

#### Direct Healthcare Liability Segment

The direct healthcare liability segment represents professional liability insurance and medical malpractice insurance written directly by the Company for physicians, surgeons, hospitals and other healthcare providers.

Before the acquisition of the Company in 1996, the insurance group concentrated its operations on the sale of medical malpractice insurance in the state of California. The

acquisition of the Company in 1996 was to expand the operations of the Company on a national basis.

In 1996, the Company undertook an expansion plan that included products that offered comprehensive hospital and related liability coverage for large healthcare systems. These policies were written through national and regional brokers and covered facilities in four states in addition to California.

Commencing January 1, 1998, the Company and Brown & Brown entered into an agreement to geographically expand the Company's physician and small medical group market in selected states outside the state of California. In 2000, the Company also entered into an agreement to cover various dental liability programs developed by Brown & Brown and to reinsure the entire risk on other policies issued through another insurer that were marketed by Brown & Brown.

In 2001, the Company began offering its liability products to physicians in the state of Delaware. The business is produced through a single Delaware broker.

#### Assumed Reinsurance Segment

See the "Reinsurance" caption of the Examination Report for details.

#### Discontinuance of Business

During 2000, the Company incurred material adverse loss experience related its large hospital and other healthcare facility policies. As a result, the Company began exiting the hospital market by declining to renew these policies or by offering renewal only at substantially

increased premium rates. As of December 31, 2002, all of the hospital policies written by the Company had expired.

Because of adverse experience encountered in 2001 and 2002, the Company instituted rate increases, followed stricter underwriting standards for its programs and also decreased the number of policyholders. Significant losses were recognized on medical malpractice insurance issued outside the states of California and Delaware (primarily under Brown & Brown and non-standard physician programs). In 2001 and 2002, the Company derived approximately 29% and 30% of its healthcare liability premium volume, respectively, from policies issued outside those states. During 2002, the Company continued to issue and renew both standard and non standard policies under the Brown & Brown program subject to more stringent underwriting requirements. As a result, the policies in force that related to the Brown & Brown program significantly decreased.

Due to losses on medical malpractice policies issued to physicians and medical groups in states outside of California and Delaware, the Company began a withdrawal from all healthcare liability insurance outside of these two states. After March 6, 2003, no new or renewal business was written in connection with programs administered by Brown & Brown. The Company and Brown & Brown agreed to terminate the physician and dental programs no later than March 6, 2003. The Brown and Brown business is currently in run-off.

As indicated under the “Reinsurance” caption, the Company also experienced significant losses in 2001 and 2002 from the non-California assumed reinsurance operations and in its assumed reinsurance operations related to the September 11, 2001 World Trade Center terrorist attacks. In December 2002, the Company decided to no longer pursue assumed reinsurance as part of its core business by December 31, 2003, the Company had terminated or cancelled all

treaties as to new business. Most of the run-off obligation on the assumed reinsurance business was retroceded to Goshawk Re Ltd. (“Goshawk”). See “Reinsurance” caption for additional details regarding the Assumed Reinsurance.

The effect of the losses sustained by the Company in 2001 and 2002 on the capitalization in relation to the premium written in those years resulted in a downgrade in the Company’s A.M. Best rating from A (Excellent) in 2001 to B+ (Very Good) in 2002 and to B (Fair) in 2003.

As the result of the Company’s withdrawal from certain segments of its business operations as indicated above, the Company is currently engaged in a plan of operation that returns the Company to its core business, one that focuses on its medical malpractice business, limited to the marketing of professional and related liability policies to physicians and other healthcare providers located in the states of California and Delaware. The Company no longer issues new non-standard policies outside the state of California. The Company does not expect to initiate any significant new programs outside of California and Delaware in the near future. The Company will seek new opportunities when it is prudent to do so; predicated on states’ tort reform measures.

The Company does not utilize managing general agents or third party administrators. The Company is not a member of any rating bureau.



## **GROWTH OF COMPANY**

The following amounts were obtained from the Company's filed Annual Statements and highlight the results of Company operations from its last examination, 1999, to this examination, 2003.

Year	Admitted Assets	Surplus as Regards Policyholders	Gross Written Premium	Net Written Premium	Net Underwriting Gain (Loss)	Net Income (Loss)
1999	\$61,678,517	\$27,927,402	\$55,913,196	\$6,448,197	\$ (804,897)	\$2,310,593
2000	72,155,695	36,020,563	112,858,574	9,200,011	(6,294,171)	1,712,379
2001	101,851,633	37,335,456	183,405,804	14,374,070	(1,628,449)	(2,486,899)
2002	122,749,589	39,515,920	163,839,678	12,667,584	(4,311,170)	867,203
2003	128,148,535	32,602,593	89,262,486	7,398,142	(2,295,843)	(1,098,621)

As illustrated above, admitted assets steadily increased from 1999 to 2003. The Company experienced increases or growth in Surplus as Regards to Policyholders from 1999 to 2002, but a decrease from 2002 to 2003, for reasons already discussed.

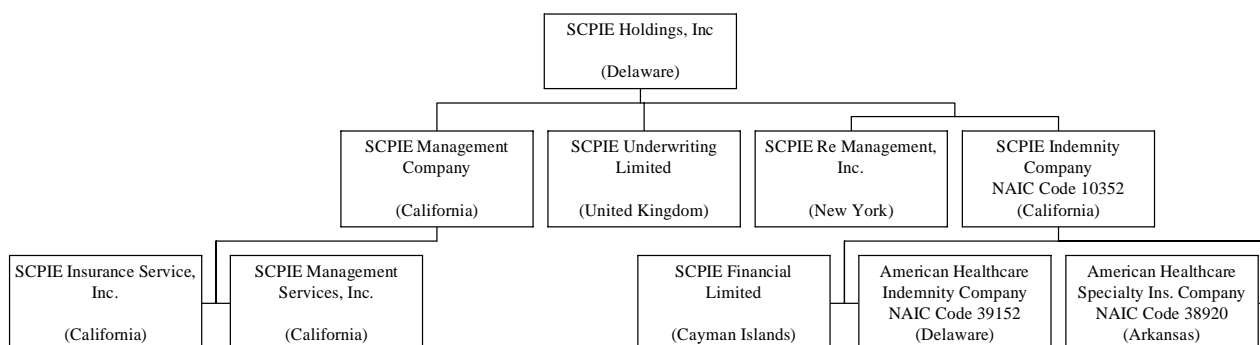
As a result of its underwriting losses, there were decreases in net income from 1999 to 2000, and a net loss in 2001 of \$2,486,899. The Company's net loss in 2001 increased to a net income of \$867,203 in 2002, but then decreased to a net loss of \$1,098,621 in 2003.

The increase in Surplus as Regards Policyholders in 2000, even though there was a decrease in net income, was mainly due to a surplus contribution of \$5,000,000 from SCPIE Holdings, Inc. The increase in Surplus as Regards policyholders in 2001, even though there was a net loss 2001, was mainly due to the cumulative effect of changes in accounting principles of \$3,572,947.

## **HOLDING COMPANY SYSTEM**

The Company is a member of an Insurance Holding Company System. From a review of the Company’s filed Form B Holding Company Registration Statements and as discussed under the History section of this report, there were changes in the organizational structure during the period under examination.

As of December 31, 2003, American Healthcare Indemnity Company was a wholly-owned subsidiary of SCPIE Indemnity Company. The organizational structure of the Insurance Holding Company System as of December 31, 2003 is reflected as follows:



Based on our review of the “Form B Holding Registration Statements” filed with the Delaware Insurance Department during the period under examination, the Company has complied with the provisions of Regulation 13 of the Delaware Insurance Code.

## **INTERCOMPANY AGREEMENTS**

The Company had the following management agreements and arrangements in effect as of December 31, 2003:

### **Management Agreement**

The Company is party to a management agreement originally entered into on March 29, 1996, but amended and restated on March 31, 2001. This Amended and Restated Management Agreement is between the Company and SCPIE Management Company (Manager), an affiliated California corporation, whereby the Manager manages the Company's general business and financial affairs including the following:

Develop and prepare policy forms, solicit policyholders, risk analysis, underwriting, rating and policy issuance, policy cancellation, claims processing, reinsurance acquisition, receipt and deposit of insurance proceeds, invest and reinvest assets in accordance with specific investment directives, reserve establishment, maintenance of books and records, regulatory filings, lease or provide office space necessary, obtain and maintain all necessary bonds, employ all levels of personnel necessary to conduct the business, prosecute and defend legal action, and perform any such other services as it deems reasonable.

As compensation for these services, the Company shall reimburse the Manager for all costs and expenses (direct and indirect) incurred in the performance of duties.

### **Consolidated Federal Income Tax Agreement**

Effective January 1, 1997, the Company along with its affiliates entered into a Tax Allocation Agreement. This Agreement is made by and among SCPIE Holdings, Inc., American Healthcare Indemnity Company, SCPIE Management Company, SCPIE Indemnity Company, FG Casualty Company, SCPIE Insurance Services, Inc. and SCPIE Management Services.

The Agreement sets forth 22 mutual covenants and promises that all participants

have agreed to follow. The Agreement provides 1) that the federal income tax to be paid or received from the parent company be based on the insurance company's taxable income or taxable loss on a separate return basis 2) that tax benefits attributable to operating losses, investment credits and other carryovers are recognized when utilization of these benefits is assured by SCPIE Holdings, Inc. and 3) that allocation of federal income tax is based upon separate return calculations with current credit for operating losses, investment credits and other carryovers.

Settlements are to be made no later than 30 days after the date of filing of the consolidated federal tax return. Payments for any assessment or adjustments are to be made within 30 days of the assessment/adjustment notice. Termination is by written notice of the member.

**Inter-Company Pooling Agreement:**

The Company participates in an Inter-Company reinsurance pooling agreement, dated March 31, 2001, effective as of January 1, 2001. Refer to the "Reinsurance" caption for further details.

## **REINSURANCE**

**Inter-Company Reinsurance Pooling Agreement**

The Company participates in an intercompany pooling agreement that first commenced in 1996. The current agreement, effective as of January 1, 2001, is between the Company, its parent, SCPIE Indemnity Company and its affiliate, American Healthcare Specialty Insurance Company.

The pooling consists of all gross in-force, new and renewal business as well as all gross reported and incurred but not reported claims and losses, statutory liabilities and assets held against them, past due balances and underwriting expenses.

Under the terms of the pooling agreement, the Company and American Healthcare Specialty Insurance Company cede all business for policy years 1996 and after to SCPIE Indemnity Company. All business written by each of the pool participants is subject to pooling, however reinsurance may be ceded by any pool participant prior to the pooling. Each pool participant has a contractual right of direct recovery from its own reinsurers.

Terms of the Agreement indicate cession to the pool and cession from the pool and include the following:

Cession to Pool

Each Pool Member individually shall cede to SCPIE Indemnity and SCPIE Indemnity shall assume from each Pool Member:

- a) 100% of the Gross Losses of Pool Member on all classes of inforce, new and renewal business (effective April 1, 1996 on original 1996 agreement and effective January 1, 1999 on the 2001 most current agreement) including statutory liabilities and assets held against them, and past due balances.
- b) 100% of the Gross Unearned Premium on each and every risk in force ("as of the effective date" on the original 1996 agreement and January 1, 1999 on the 2001 most current agreement) and 100% of the Gross Written Premium on each and every risk assumed thereafter by way of primary insurance, reinsurance and retrocession.
- c) SCPIE Indemnity shall credit Pool Members with (i) a ceding commission on Gross Unearned Premium reserve. The ceding commission will be an amount equal to the actual cost incurred by the respective Pool Member for Underwriting Expenses. (ii) 100% of the amount of all Gross Expenses paid by the Pool Members while this Agreement is in force, except United States federal and any state income tax and investment expenses.
- d) Each Pool Member shall credit SCPIE Indemnity with 100% of the reserves on its book for unpaid expenses, excluding the reserves for United States federal and any state income tax and investment expenses, outstanding on the Effective Date.
- e) All reinsurance other than certain facultative reinsurance placements in effect on or before January 1, 1999, and that ultimately ceded hereunder Pool Members shall be placed by SCPIE Indemnity on behalf of the Pool Members and each Pool Member

shall participate in such reinsurance in proportion to its respective percentages of participation ("Pool Share").

Cession from Pool

Pool Members shall reinsure and SCPIE Indemnity shall cede and transfer to Pool Members as follows:

- a) SCPIE Indemnity shall add business ceded to it to its own business thus forming a pool (called the "SCPIE Pool") which shall then be redistributed by SCPIE Indemnity in accordance with Pool Share.
- b) Pool Members shall reinsure, and SCPIE Indemnity shall cede and transfer to Pool Members, their respective Pool Share of the SCPIE Pool's Ultimate Net Liability under all policies and contracts of insurance on which the SCPIE Pool is subject to liability and which are outstanding and in force at the Effective Date of this Agreement.
- c) SCPIE Indemnity hereby cedes and the Pool Members hereby assume their respective Pool Shares of the SCPIE Pool's Ultimate Net Liability for Net Losses payable while this agreement is in force.
- d) Premium to the Pool Members for their respective Pool Shares of the reinsurance shall be their respective Pool Shares of the Net Unearned Premium on each and every risk in force as of the Effective Date and their respective Pool Shares of the Net Written Premium on each and every risk assumed thereafter by way of primary insurance, reinsurance or retrocession.
- e) The Pool Members shall credit SCPIE Indemnity with (i) a ceding commission on the Net Unearned Premium reserve transferred. The ceding commission will be an amount equal to each Pool Members's respective Pool Share of the actual cost incurred by SCPIE Indemnity for Underwriting Expenses relating to such Net Unearned Premium reserve, (ii) their respective Pool Share of the amount of all Net Expenses incurred by SCPIE Indemnity while this Agreement is in force, except United States federal and any state income tax and investment expenses.
- f) SCPIE Indemnity shall credit the Pool Members with their respective Pool Shares of the net pooled reserves on its books at the Effective Date for unpaid expenses, excluding the reserves for United States federal and any state income tax and investment expenses.

As indicated above, the pooling participants assume a percentage of the pool's ultimate net liability for premiums, losses and expenses. Premiums, losses and expenses are distributed according to the participation percentages below and also the balances in various Annual Statement balance sheet items including Agents' Balances or Uncollected Premiums, Losses, Loss Adjustment Expenses, Other Expenses, and Unearned Premiums. During the period under

examination, the pooling participants and their percentage participation in the pooled results were as follows:

SCPIE Indemnity Company	90%
American Healthcare Indemnity Company	5%
American Healthcare Specialty Insurance Company	5%

According to the Agreement, settlements of expenses are to be made within 45 days following the end of each month. The Company indicates that it settles amounts due from its affiliates under its Inter-Company Pooling Agreement within forty-five (45) days following the end of each quarter. This settlement of amounts deviates from the monthly settlements called for and described in the Company's Inter-company Pooling Agreement.

**It is recommended that the Company amend its Inter-Company Pooling Agreement to reflect the actual manner in which the amounts or balances are settled.**

### **Assumed Reinsurance**

In August 1999, the Company began actively pursuing assumed reinsurance as part of its core business. The Company concentrated the majority of its reinsurance portfolio in treaty reinsurance on a pro-rata or quota share basis. The primary reinsurance programs included casualty, property, accident and health, and workers' compensation programs and a marine program.

The Company experienced significant losses in 2001 and 2002 from the non-California assumed reinsurance operations and from its assumed reinsurance operations related to the September 11, 2001 World Trade Center terrorist attacks.

In December 2002, the Company decided to no longer pursue assumed reinsurance as part of its core business, and as of December 31, 2003, the Company had terminated or cancelled all treaties as to new business. Most of the run-off obligation on the assumed reinsurance business was retroceded to Goshawk Reinsurance Limited (“Goshawk”). Goshawk Reinsurance Limited is currently known as Rosemont Reinsurance Limited (“Rosemont Re”).

The Company, SCPIE Indemnity Company and American Healthcare Specialty Insurance Company entered into the reinsurance agreement with Goshawk whereby they ceded the majority of the written and earned premium retailed to their assumed reinsurance program after July 1, 2002. Refer to the “Ceded Reinsurance” caption for further details.

At December 31, 2002, the only assumed reinsurance treaty in effect was the Lloyd’s Syndicate #1204 – Kiln. All other assumed reinsurance was in run-off. The Lloyd’s Syndicate #1204 – Kiln treaty was extended to the 2003 underwriting year.

The assumed reinsurance business segment from non-affiliates increased from \$8.7 million in 1999 to \$93.8 million in 2002 but decreased to \$37.9 million in 2003.

### **Ceded Reinsurance**

The Company and SCPIE Indemnity Company and American Healthcare Specialty Insurance Company entered into a 100% Quota Share Retrocession Contract (“Goshawk Agreement”) with Goshawk Reinsurance Limited (“Goshawk”) in December 2002. Goshawk Reinsurance Limited is currently known as Rosemont Reinsurance Limited (“Rosemont Re”).

The Goshawk Agreement includes terms to retrocede to Goshawk the majority of reinsurance business written in 2001 and 2002. The Goshawk Agreement covers the 2001 and 2002 underwriting years of the business assumed. Goshawk agreed to reimburse direct



acquisition cost and assume (on an unlimited basis) the majority of the written and earned premium related to the Company's assumed reinsurance program after July 1, 2002.

Losses related to premiums earned prior to July 1, 2002, remain the obligation of the Company, including those losses related to the World Trade Center terrorist attacks. Under the Company's intercompany pooling arrangement, the Company's proportionate share is 5%. Both prospective and retrospective elements are part of the Goshawk agreement.

In addition to the premium ceded to the reinsurer, the agreement calls for an additional premium of 14.3%. This additional premium is expensed as the basis premium is ceded. The additional premium obligations are collateralized by securities. The agreement requires funds to be held in trust to collateralize Goshawk Re's obligation under the agreement.

Goshawk Re, is a subsidiary of Goshawk Insurance Holdings. Plc, a publicly held London-based insurer and reinsurer. Goshawk Re divested substantially all of the Company's ongoing assumed reinsurance operations. The Company has one ongoing assumed reinsurance treaty for the 2003 underwriting year.

The Company along with SCPIE Holdings, Inc., SCPIE Indemnity Company, American Healthcare Specialty Company, SCPIE Insurance Services, Inc. and SCPIE Management Services are parties to an Excess of Loss Reinsurance Agreement effective January 1, 2003 to December 31, 2003. Lines of business covered are physicians and surgeons comprehensive professional and business liability, professional and business liability policies for hospitals and healthcare facilities, errors and omissions liability policies for managed care organizations and physicians and surgeons comprehensive professional liability and personal umbrella business. The Company's retention and reinsurers' maximum limits are as follows:

Type of Contract	Reinsurer(s) Name	Company's Retention	Reinsurer's Maximum Limits
<b><u>Excess of Loss</u></b>			
First Layer	40.01% Various Lloyd's of London Syndicates 37.50% Hannover Ruckversicherungs 5.00% Goshawk Reinsurance Limited	\$2,000,000	\$3,000,000 xs \$2,000,000
Second Layer	37.61% Various Lloyd's of London Syndicates 32.50% Hannover Ruckversicherungs 10.00% Goshawk RE Limited	\$5,000,000	\$5,000,000 xs \$5,000,000
Third Layer	69.25% Various Lloyd's of London Syndicates 15.00% Hannover Ruckversicherungs	\$10,000,000	\$10,000,000 xs \$10,000,000
Fourth Layer	44.00% Lloyd's of London Syndicates 20.00% Goshawk RE Limited 15.00% Hannover Ruckversicherungs 5.00% Wellington Underwriting, Inc.	\$20,000,000 \$ 4,800,000 *	\$30,000,000 xs \$20,000,000

\* - Represents 16% of layer not placed with reinsurers

The Company along with SCPIE Holdings, Inc., SCPIE Indemnity Company, American Healthcare Specialty Company, SCPIE Insurance Services, Inc. and SCPIE Management Services are parties to a Per Policy Excess of Loss Reinsurance Agreement effective January 1, 2003 to December 31, 2003. Lines of business covered are physicians and surgeon's comprehensive professional and business liability. The Company's retention and reinsurers' maximum limits are as follows:

<b><u>Per Policy XOL</u></b>			
	100.00% Hannover Rueckversicherungs	\$5,000,000	\$5,000,000 xs \$5,000,000

## **ACCOUNTS AND RECORDS**

The accounts and records reviewed included an evaluation of the Company's operational and organizational controls. The areas evaluated included computer systems, accounting systems, organizational structure, and the processing structure. In general, it has been determined that the Company does have a sufficient level of controls in place for the above areas.

All necessary accounting records of the Company are maintained on electronic data processing equipment. The general ledger is maintained on a statutory basis with additional accounts used to convert to the accrual basis suitable for General Accepted Accounting Principles.

The Company's trial balance was traced to the various schedules and exhibits in its filed 2003 Annual Statement.

## **FINANCIAL STATEMENTS**

The following statements show the assets, liabilities, surplus and other funds of the Company, as determined by this examination, as of December 31, 2003:

Analysis of Assets  
Liabilities, Surplus and Other Funds  
Underwriting and Investment Exhibit  
Surplus as Regards Policyholders, 1999 to 2003  
Schedule of Examination Changes

It should be noted that the various schedules and exhibits may not add to the totals shown due to rounding. With the exception of Losses and Loss Adjustment Expenses, any write-ups on the individual accounts in the Notes to the Financial Statements section of this report are presented on the “exception basis”, therefore only comments relative to adverse findings, material financial changes, or other significant regulatory concerns are noted.

**Analysis of Assets**  
**December 31, 2003**

<u>Assets</u>	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	\$96,177,696		\$96,177,696	(1)
Common stocks	847,210		847,210	(1)
Cash and short-term investments	8,429,834		8,429,834	(1)
Investment income due and accrued	1,294,935		1,294,935	
Uncollected prem. & agents' bal. in course of coll.	9,182,379	\$60,411	9,121,968	
Amounts recoverable from reinsurers	1,600,193		1,600,193	
Funds held by or deposited with reinsured companies	9,502,967		9,502,967	
Net deferred tax asset	2,254,051	1,098,891	1,155,160	
Electronic data processing equipment and software	276	276	0	
Furniture and equipment	27,314	27,314	0	
Other Assets	18,572		18,572	
Goodwill	<u>2,400,000</u>	<u>2,400,000</u>	<u>0</u>	
Total assets	<u>\$ 131,735,427</u>	<u>\$ 3,586,892</u>	<u>\$ 128,148,535</u>	

**Liabilities, Surplus and Other Funds**  
**December 31, 2003**

Losses		\$20,363,593	(2)
Loss adjustment expenses		6,766,324	(2)
Commissions payable		1,028,894	
Taxes, licenses and fees		(216,917)	
Federal and foreign income taxes		18,239	
Unearned premiums		1,768,239	
Advance premiums		343,525	
Ceded reinsurance premiums payable		475,820	
Funds held by company under reinsurance treaties		40,253,525	
Provision for reinsurance		3,861,000	
Drafts outstanding		2,717,030	
Payable to parent, subsidiaries and affiliates		30,890,564	
Aggregate write-ins for liabilities:			
Retrospective losses		(11,367,872)	
Unapplied cash		(1,356,022)	
Total Liabilities		<u>95,545,942</u>	
Common capital stock	\$ 5,000,000		
Gross paid-in and contributed surplus	39,264,000		
Unassigned funds (surplus)	<u>(11,661,407)</u>		
Surplus as regards policyholders		<u>32,602,593</u>	
Total liabilities, capital and surplus		<u>\$ 128,148,535</u>	

**Underwriting and Investment Exhibit**  
**Statement of Income**  
**December 31, 2003**

**Underwriting Income**

Premiums earned	\$ 8,194,344
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**Deductions:**

Losses incurred	\$ 5,971,250
Loss expense incurred	2,265,132
Other underwriting expenses incurred	1,813,593
Aggregate write-ins for underwriting deductions	<u>440,212</u>

Total underwriting deductions	<u>10,490,187</u>
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Net underwriting loss	(2,295,843)
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**Investment Income**

Net investment income earned	\$ 2,467,949
Net realized capital losses	<u>(1,274,457)</u>

Net investment gain	1,193,492
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**Other Income**

Aggregate write-ins for miscellaneous income	<u>\$ 297,247</u>
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Total other income	<u>297,247</u>
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Net loss before federal income taxes	(805,104)
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Federal income taxes incurred	<u>293,517</u>
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Net loss	<u>\$ (1,098,621)</u>
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**Capital and Surplus Account**

Surplus as regards policyholders, December 31, 2002	\$ 36,849,253
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Net loss	\$ (1,098,621)
Change in net unrealized capital losses	(594,392)
Change in net unrealized foreign exchange capital loss	(309,055)
Change in net deferred income tax	1,971,252
Change in nonadmitted assets	(705,441)
Change in provision for reinsurance	<u>(3,510,403)</u>
Change in surplus as regards policyholders	<u>(4,246,660)</u>
Surplus as regards policyholders, December 31, 2003	<u>\$ 32,602,593</u>

**Surplus as Regards Policyholders**  
**December 31, 1999 to December 31, 2003**

Surplus as Regards Policyholders, December 31, 1999		<u>\$26,620,474</u>
Net Income		1,304,655
<u>Additions:</u>		
Change in net unrealized capital gain	\$228,614	
Change in net unrealized foreign exchange capital gain	7,050	
Change in net deferred income tax	1,796,200	
Cumulative effect of changes in accounting principles	439,614	
Change in excess of statutory reserves over statement reserves	18,000	
Capital changes – paid in	2,500,000	
Surplus adjustments – paid in	2,500,000	
Total Additions		\$7,489,478
<u>Deductions:</u>		
Change in non-admitted assets and related items	\$(467,985)	
Change in provision for reinsurance	3,279,999	
Total Deductions		<u>2,812,014</u>
Net increase in surplus as regards policyholders		<u>5,982,119</u>
Surplus as Regards Policyholders, December 31, 2003		\$32,602,593

**SCHEDULE OF EXAMINATION CHANGES**

As a result of this examination, no financial adjustments were made for examination report purposes.

## **NOTES TO FINANCIAL STATEMENTS**

**Note 1****Bonds**

\$ 96,177,696

**Common Stocks**

\$ 847,210

**Short-term Investments**

\$ 8,429,834

Procedures were performed to confirm the existence and ownership of the investments reported in Schedule D - Part 1, Schedule D – Part 2-Section 2 and Schedule DA-Part 1. These procedures were performed without exception.

The Company's custodial agreement does not contain all the recommended safeguards and controls as required by the NAIC. The custodial agreement does not maintain the required provision related to the registration of the custodial securities, or the separate identification requirement for securities held in fungible bulk by the custodian, in a clearing corporation, or in the Federal Reserve book-entry system. Also, the custodial agreement does not refer to the "Delaware Department of Insurance" in its termination provision.

**It is recommended that the Company revise its custodial agreement to include all of the pertinent provisions indicated by the NAIC. It is also recommended that the Company include the "Delaware Department of Insurance" as part of the termination provision of its custodial agreement.**

During the process of this examination, custodial safeguards and control issues were brought to the attention of the Company. The Company and the custodian are currently in the process of resolving these issues by making the recommended changes to the custodial agreement.



**Note 2**

**Losses**

**\$ 20,363,593**

**Loss Adjustment Expenses**

**\$ 6,766,324**

As noted under the caption “Reinsurance”, the Company is part of an inter-company reinsurance pool with its parent, SCPIE Indemnity Company and its affiliate, American Healthcare Specialty Insurance Company. SCPIE Indemnity Company is the lead company in the pool. In conjunction with the SCPIE Indemnity Company pooled examination, the California Insurance Department’s actuarial analysis and report was also utilized and accepted for this American Healthcare Indemnity Company examination.

To assist with the actuarial analysis including the determination of the reasonableness of the Company’s loss and loss adjustment expense reserves, the California Department of Insurance retained the actuarial firm of American Actuarial Consulting Group, L.L.P. (AACG). Based upon the analysis by AACG and the review of AACG’s work by a California Department of Insurance casualty actuary, the reserves for losses and loss adjustment expenses were determined to be reasonable.

Although the Company’s reserves for losses and loss adjustment expenses were found to be reasonable, the examiners experienced difficulty reconciling the underlying data to Schedule P of the Annual Statement.

**It is recommended that the Company implement procedures to compile detail loss working papers, which reconcile to the annual statement.**

## **MARKET CONDUCT ACTIVITIES**

The market conduct review of the American Healthcare Indemnity Company, hereinafter referred to as the “Company”, covered the period from January 1, 1999 through December 31, 2003 and was conducted simultaneously with the Financial Examination of the Company.

A review was made of the Company’s market conduct activities with regard to its business practices and ability to fulfill its contractual obligations to policyholders and beneficiaries. Records and documentation relevant to these operations were reviewed. A summary of the results of the market conduct activities which were reviewed follows:

### **Sales and Advertising**

The Company’s promotional advertising materials, were reviewed and it was determined that they were in compliance with the provisions of Section 2304 of the Delaware Insurance Code. Generally speaking the advertising materials used by the Company describe its products with propriety and it appears that the Company is not using any unfair or deceptive practices.

### **Underwriting**

A sample of policy and application files was selected for review. The review was performed to ascertain the Company’s practices with regard to the following areas: compliance with policy provisions; compliance with underwriting guidelines; consistency in the application of underwriting standards; compliance with applicable statutes and regulations; accuracy of return premium calculations; prompt notification of declination or rescission; and unusual decisions made by underwriting personnel. No significant exceptions were noted.

### **Policy Forms**

Through a review of the policy forms in use during the period under examination, it was determined that they had all been properly filed with the Insurance Department. Through a sampling of policy files it was determined that none of the policies sampled had been issued prior to the Company obtaining the proper approval. This testing also confirmed that the forms had been properly approved by the other individual states.

A review of the Company's policy forms approval guidelines resulted in the determination that the guidelines appear to be reasonable.

### **Claims Practices**

A review was conducted of the Company's current claims processing procedures from initial report through settlement. The procedures are comprehensive and adequately documented. The information requested of the claimants is reasonable as well as thorough.

Copies of the Company's Claims Registers (claims download), for the period under examination, were requested and obtained. Totals of claims contained in the registers were traced and agreed to the Company's general ledger or copies of its Annual Statement.

The Company's claims register was reviewed and verified to actual claim files on a sample basis. It was determined that the data reported in the claims register was adequate and that the Company acknowledged communications from the claimants in a timely manner. Interest was paid on applicable claims, and claims were settled by the Company in a timely and equitable manner.

The Company reported that there were no denied or resisted claims during the period under examination.

### **Complaint Handling**

A comprehensive review was conducted of the Company's complaint handling process. Complaint logs were reviewed for the period under examination. It was determined that, generally speaking, the logs had been maintained in accordance with provisions of Section 2304 (17) of the Delaware Insurance Code regarding complaint logs.

A review of the actual complaint files revealed that the Company appears to be handling complaints promptly, in a fair and courteous manner.

## **COMPLIANCE WITH PRIOR EXAMINATION RECOMMENDATIONS**

The Company's compliance with prior examination recommendations was reviewed. There was one recommendation made in the prior examination report that the Company still has not complied with, and therefore a repeat recommendation will be made in this report. See the caption "Summary of Recommendations – Inter-Company Pooling Agreement" below for further details.

## **SUMMARY OF RECOMMENDATIONS**

### **Inter-Company Pooling Agreement**

It is again recommended that the Company amend its Inter-Company Pooling Agreement to reflect the actual manner in which the amounts or balances are settled. (Page 20)

### **Bonds, Stocks and Short-term Investments**

It is recommended that the Company obtain a custodial agreement with its depository institution that contains all safeguards and controls, as recommended by the NAIC. The custodial agreement should also include a revision of the termination provision to include the “Delaware Department of Insurance”. (Page 29)

### **Losses and Loss Adjustment Expenses**

It is recommended that the Company implement procedures to compile detail loss working papers, which reconcile to the Annual statement. (Page 30)

## **CONCLUSION**

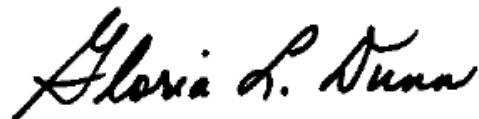
The following schedule shows the results of this examination and the results of the prior examination with changes between the examination periods:

<b><u>Description</u></b>	<b><u>December 31, 1999</u></b>	<b><u>December 31, 2003</u></b>	<b><u>Increase</u></b>
Assets	\$61,678,517	\$128,148,535	\$66,470,018
Liabilities	33,751,115	95,545,942	61,794,827
Surplus as Regards Policyholders	27,927,402	32,602,593	4,675,191

## **ACKNOWLEDGEMENT**

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of examination.

Respectfully submitted,

A handwritten signature in black ink, reading "Gloria L. Dunn". The signature is written in a cursive style with a large initial "G" and "D".

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Gloria L. Dunn, CFE, CIE  
Examiner-In-Charge  
State of Delaware  
Northeastern Zone, NAIC

## **SUBSEQUENT EVENTS**

### **Contingent Liability / Highlands Insurance Group**

The Company is party to a Cut-through Endorsement Agreement (Highlands Agreement), dated January 1, 2000 with Highlands Insurance Group, Inc. (HIG). Endorsements were issued by the Company, between January 1, 2000 and April 30, 2001 to certain policyholders of insurance company subsidiaries of HIG. The coverages under the Highlands Agreement included property, workers' compensation, commercial automobile, general liability and umbrella.

Provisions of the Highlands Agreement indicated that in the event that HIG (which includes Highlands insurance company subsidiaries) is declared insolvent by a court of competent jurisdiction, the Company will assume 100% of HIG's gross liabilities under all policies, contracts and binders of insurance to which a Cut-Through Endorsement naming the Company has been attached and becomes effective on or after the effective date of the agreement. Should other HIG subsidiaries in other jurisdictions be judged insolvent and HIG be unable to meet policyholder obligations, the Company would be responsible for a 5% share of the net losses in compliance with the terms of the intercompany pooling agreement.

According to a Form 10-Q, dated September 30, 2004, filed with the United States Securities and Exchange Commission:

During 2002 and 2003, all of the HIG insurance company subsidiaries (with the exception of a California subsidiary) were merged into a single Texas domiciled subsidiary, Highlands Insurance Company (Highlands). Highlands has advised the Company that the HIG insurance company subsidiaries have paid losses and LAE under the subject policies of more than \$65.0 million and that at September 30, 2004 had established case loss reserves of \$11.0 million, net of reinsurance. Based on a limited review of the exposures remaining, the Company estimates that incurred but not reported losses range from \$6.0 million to \$7.0 million for a total loss and loss expense reserve of

\$17.0 million to \$18.0 million. This estimate is not based on a full reserve analysis of the exposures. To the extent Highlands is declared insolvent at some future date by a court of competent jurisdiction and is unable to pay losses under the subject policies, the Company would be responsible to pay the amount of the losses incurred and unpaid at such date and would be subrogated to the rights of the policyholders as creditors of Highlands. The Company may also be entitled to indemnification of a portion of this loss from certain of Highlands' reinsurers.

On November 6, 2003, the State of Texas obtained an order in the Texas District Court appointing the Texas Insurance Commissioner as the permanent Receiver of the Highlands and placing the Receiver in possession of all assets of Highlands. The order expressly provided that it did not constitute a finding of Highlands' insolvency nor an authorization to liquidate Highlands. The Receiver subsequently became involved in a large litigation matter, which precipitated the Receiver filing an application for a hearing to liquidate Highlands. That litigation has recently been settled, and no liquidation hearing is presently pending. The Receiver continues to resolve Highlands claim liabilities and otherwise conduct its business, as part of his efforts to rehabilitate Highlands. If an order of liquidation is ultimately entered and becomes final, the Company would likely be required to assume Highlands' then remaining obligations under the subject policies.

In conjunction with the SCPIE Indemnity Company pooled examination, the California Department of Insurance (CDI), retained an independent actuary in order to determine the Company's potential exposure under the terms of the cut-through endorsement. The actuarial review estimated the remaining unpaid losses as of December 31, 2002 to be approximately \$35.1 million. During the period from December 31, 2002 through June 30, 2004 approximately \$14.4 million was paid by HIG on claims covered by the cut-through endorsement. As of June 30, 2004, the remaining unpaid liability was approximately \$21.1 million and the Company's five per cent (5%) share under the pooling agreement is approximately \$1.05 million. Further payments by HIG continue to reduce the Company's potential exposure under the terms of the Cut-Through Endorsement Agreement.

In accordance with Statements of Statutory Principles (SSAP) No. 5, if both the probability and a reasonable estimate conditions are not met there is no requirement to record a



loss contingency. Based on these requirements, no liability was established for purposes of this examination report. In the event that HIG is declared insolvent and placed into liquidation, the Company would be required to establish a liability for any remaining losses. Until such time, the Company should continue to disclose in its financial statements the nature of the contingency and include an estimate of the possible loss or range of loss or state that such an estimate cannot be made.